

The Legal Intelligencer

THE OLDEST LAW JOURNAL IN THE UNITED STATES 1843-2009

PHILADELPHIA, WEDNESDAY, APRIL 22, 2009

VOL 239 • NO. 77 An incisivemedia publication

WHITE-COLLAR LAW

Indemnification and Fee Advancement: Strategies to Avoid Unwanted Bills

BY MATTHEW FARANDA-DIEDRICH
AND DAVID M. LAIGAIE

Special to the Legal

Corporations routinely indemnify their employees and directors who face liability for actions taken in the course and scope of their work. Corporations also regularly advance, that is pay up-front, the cost of representation for these employees and directors. As this article discusses, a corporation should be careful in drafting its by-laws in order to avoid paying in cases where its interests are not being furthered.

Corporate bylaws frequently include broad provisions providing for current and former employees and directors to be repaid any legal expenses incurred while serving at the request of the company. Courts recognize that such incentives are needed to reassure qualified candidates that taking on management positions will not expose them to potentially massive legal costs. Such costs often arise from legal challenges by shareholders to decisions made by directors and officers. Most of the time, the conclusions reached by the directors and officers are consistent with the company's point of view, and thus reimbursement is a mutually advantageous process. Other times, it is less harmonious.

Under Delaware law (where a majority of publicly traded companies are incorporated), broad and mandatory bylaws may lead to undesirable results. Bylaws usually provide for reimbursement both during a legal action



DIEDRICH



LAIGAIE

MATTHEW FARANDA-DIEDRICH is an associate at Dilworth Paxson. He practices commercial litigation in both state and federal courts with an emphasis on secured lending matters, officer and director liability and complex construction and development law. He can be reached at 215-575-7326 or mfd@dilworthblaw.com.

DAVID M. LAIGAIE, a partner at Dilworth Paxson, heads the corporate investigations and white-collar group. His areas of practice include health care fraud, securities fraud, tax fraud, export violations, pharmaceutical marketing fraud, municipal corruption, defense procurement fraud and public finance fraud. He regularly conducts internal corporate investigations. He can be reached at 215-575-7168 or dlaigaie@dilworthblaw.com.

(as an "advancement") and after the suit's conclusion (as "indemnification"). While both forms of repayment raise unique problems, advancement poses the far greater risk.

Most advancement bylaw provisions are generally written in a broad and all-encompassing manner, noting that advancement "shall" be made upon the occurrence of a certain event, making those disbursements mandatory and stripping the company of any discretion to limit such expenditures. Indemnification

provisions, on the other hand, are usually drafted more narrowly to cover only certain situations and, even then, as a matter of general statutory law, may not be paid unless it is determined that the individual's conduct was undertaken in "good faith" and consistent with "the best interests of the corporation."

Where advancement is mandatory and expansive, a company could be unwittingly exposing itself to liability for a variety of fees and costs. Perhaps the most bizarre consequence is that a business could end up being required to reimburse a director or officer who brings suit against the company.

In *Hibbert v. Hollywood Park Inc.*, the Delaware Supreme Court interpreted a corporation's bylaw as obligating the corporation to repay former directors for suits the directors initiated in connection with numerous proxy contests and bids for re-election to the corporation's board of directors. The court reasoned that the bylaw's phrase permitting advancement whenever an individual became involved in litigation "as a party or otherwise" was broad enough to cover such situations.

No doubt hoping to avoid the outcome of *Hibbert*, many companies subsequently redrafted their bylaws to make clear that reimbursements were only required where the director or officer were "defending" a suit. Unfortunately for those businesses, however, this change in phraseology did not prevent later courts from awarding money to directors and officers in connection with claims adverse to a company or its interests.

In *Citadel Holding Corp. v. Roven*, a corporation initiated a proceeding against a former director for alleged violations of the Securities and Exchange Act related to his purchasing of options to buy the company's stock while still a director. During the course of that suit, the director asserted certain affirmative defenses and a number of counterclaims. The director then sought advancement in Delaware state court for his expenses incurred in defending the securities suit. The advancement provision of an indemnity agreement between the company and the director required the company to pay for any costs incurred "in defending or investigating any action, suit, proceeding or investigation."

Based on this language, the trial court ordered the company to pay the director nearly \$1 million for costs the director incurred in defending the action initiated by the corporation. In upholding this award, the Delaware Supreme Court confirmed the trial court's determination that the mandatory advancement provision was not limited in scope and was broad enough to cover the defense of a suit initiated by the corporation — even a suit related to the director's alleged malfeasance. Adopting a "broad reading" of the phrase "in defense," the court further concluded that even the director's affirmative defenses and counterclaims against the corporation qualified as reimbursable expenses.

Faced with the results in *Hibbert* and *Citadel*, what is a business to do? Amending their bylaws is an obvious answer. What takes more consideration and reflection, however, is what level of reimbursement best balances a company's opposing concerns of limiting its liability exposure for frivolous claims while encouraging capable men and women to serve in management positions within the organization.

Should advancement be made

discretionary and subject to review by the board of directors? Should terms be altered to clarify that the company will not reimburse individuals for claims brought against the corporation? Should former directors be excluded from coverage? These are important choices — and, as caselaw makes clear, ones better made sooner rather than later.

Chancellor William B. Chandler III, speaking for the Delaware Court of Chancery in the case of *Tafeen v. Homestore Inc.*, articulated the problem facing companies that try to limit expansive bylaws after litigation has already begun. "The [company's] defense is novel because it reminds one of a sinner who suddenly finds religion — the conversion is breathtaking," Chandler wrote. "Content to adopt advancement and indemnification bylaws drafted with holes large enough to drive a truck through, the defendant company (like so many others in this Court of late) suddenly 'finds religion' — insisting on a rigorous interpretation of its loosely written bylaws."

Chandler's quote underscores the importance of a company being proactive in amending its bylaws instead of waiting until after a claim arises to "find religion."

After the fact bylaw amendments have little or no legal significance — as amendments cannot be applied retroactively to limit a claim for reimbursement that has already developed. Because a director's right to advancement is a contract right that vests when a claim giving rise to advancement has been asserted against the director, a company is free to alter or even eliminate this right prior to the occurrence of a reimbursable event — such as the filing of a suit against the director. However, where bylaws are amended after a claim is asserted against a director, the contract right has

already vested and, thus, is not subject to amendment.

Companies that want to avoid overly broad advancement and indemnification obligations should review and redraft bylaw provisions right away, before a reimbursable claim arises. •